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Dec. 1, 1999 LETTER 1292

THE PICTURE: November 18 may have been a key day. On that day, both the Nasdaq and the S&P hit new all-time highs. On that day, volume on the Nasdaq hit a record of over 1.5 billion shares while volume on the NYSE surged to over 1 billion shares. On the same day, both the utilities and bonds were down -- and incredibly, breadth was also down and there were more new lows than new highs on the NYSE. I thought it was one of the most divergent and extraordinary days I've ever seen.

My PTI registered no change on that day, this despite the record highs in the S&P and Nasdaq. The next few days displayed even more weakness. Please turn to the page 2 chart of the PTI. I have shown it in an enlarged version.

As matters now stand, I have "sell signals" on the D-J Utilities and the D-J Transports and the 30-year Treasury bonds. These charts are shown on pages 2 and 3. A sell signal is triggered when the exponential 34-day MA is positioned below the exponential 144-day MA -- and the given item then sinks below the 34-day MA.

Paul Macrae Montgomery of Legg Mason keeps a record of the bond yield divided by the S&P yield. The ratio (monthly basis) has hit 7.5, meaning that AAA-bond yields are now more than 7 times S&P yields. Says Paul, "Except for Japan in 1989 and Weimar Germany, this is the highest Stock/Bond ratio we are aware of in a civilized country." **Russell Comment:** Yet another dramatic indication that this is the most overvalued stock market in US history.

The economic fundamentals? Seemingly, they couldn't be better. Not only is the US in the throes of its longest boom on record, the rest of the world is now recovering. Analysts are waxing poetic over the global "Goldilocks" picture, and if there's a dark cloud anywhere, it's the cloud of rising interest rates and the specter of inflation (of course, those of us who live in the real world know that inflation isn't a specter, it's a reality -- but don't tell the Fed).

The Goldilocks View 'Round the World

Stocks Rise Globally ...

Dow Jones World (excluding U.S.) Index vs. the Dow Jones U.S. Stocks Index; reindexed to 100 on Dec. 31, 1999

And Investors Expect More

Percentage of fund managers surv believe their economies will be str year's time. U.S. managers hope t

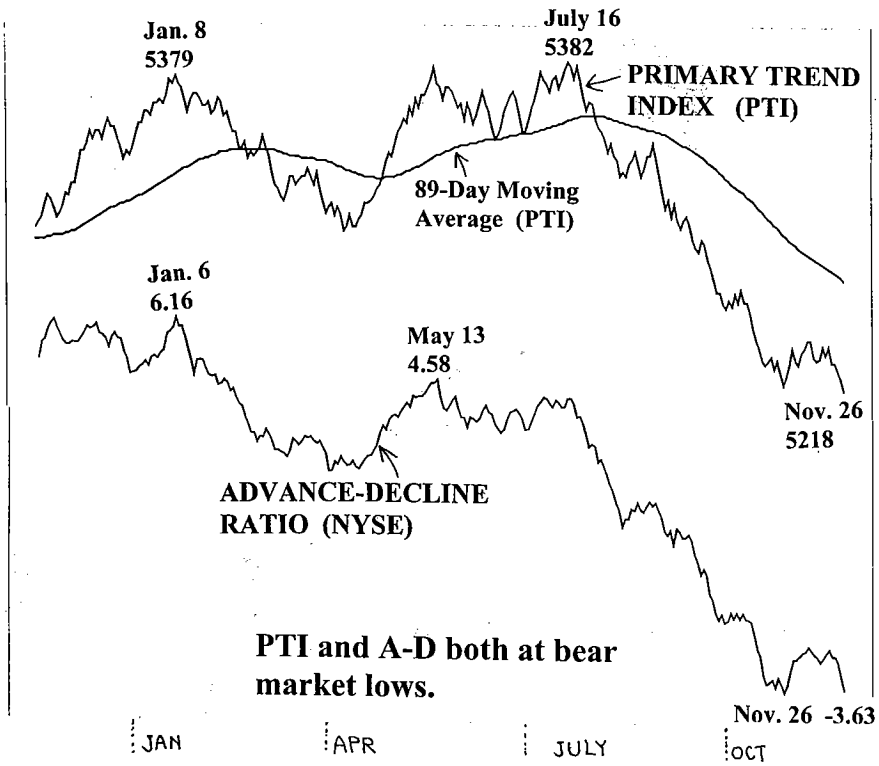
Despite nirvana in the economy, the stock market is facing a number of problems. Here are a few that I've been watching: (1) We know that the Fed has allowed the monetary reserves to run wild. This puts inflation in the pipeline. (2) Oil has shot up to well over 26 dollars a barrel -- it was below 13 last February. (3) The Goldman Sachs Commodity Index has exploded; it was 128 last December; it is now near 200. (4) Many of the stock indices have surged and are now up on parabolic spikes -- parabolas tend to be dangerous formations. I'm referring to the Nasdaq 100, the Internet Index, the Financial Index, the Semiconductor Index, and even the S&P 500. (5) The advance-decline ratio, incredibly, is still within a point of its October 26 bear market low. (6) The Utilities and bonds have both given sell signals. As veteran subscribers know, when bonds and utilities **decline together**, it's almost always bearish for the stock market. (7) The Fed has now raised rates three times. In the past, this has been a bad omen for the stock market.

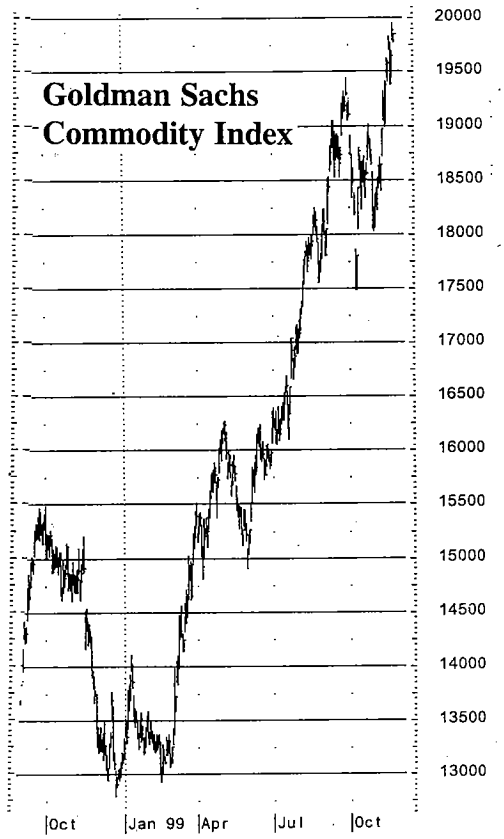
Nov. 19 DJIA 11003.99; PTI 5226; A-D Ratio -2.84
Nov. 26 DJIA 10988.91; PTI 5214; A-D Ratio -3.63
Dow Yield: 1.36%; Dow Price/Earnings: 23.7
Dow 144-day MA: 10574; Dow 34-day MA: 10745
Dow Times Book Value: 6.50; PTI 89-day exp. MA: 5271
Percentage of Undervalued Blue-chips: 9%
Gold 34-day MA: 296

It all boils down to the same picture that has existed ever since April of 1998. The picture is one in which the majority of stocks are in a bear market -- but the big averages, dominated by large-capitalization stocks, have been in bull trends. Masking the bear trend in the majority of stocks, we've had a buying-frenzy in the tech and Internet stocks. The result: A split market -- bull market in the big-cap stocks and the techs, a bear market in all the rest. Confusion, unorthodox trends, deterioration in a huge mass of stocks, upward explosion in selected groups.

I've said all along that ultimately, the market will trade as a unit, something it hasn't done since April of 1998. The trend of breadth continues down. Now the trend in bonds, utilities and Transports has turned bearish. The trend of interest rates is now bearish. My feeling is that the market is drawing closer and closer to the point where it will again trade as a unit -- and that unit trend will be bearish. When the techs and the Internets turn down along with the Nasdaq 100, breadth will turn all-encompassing. At that point, the market will cease being schizophrenic -- at that point the bear market will start to act like a true bear market, which means almost all stocks joining in on the downside.

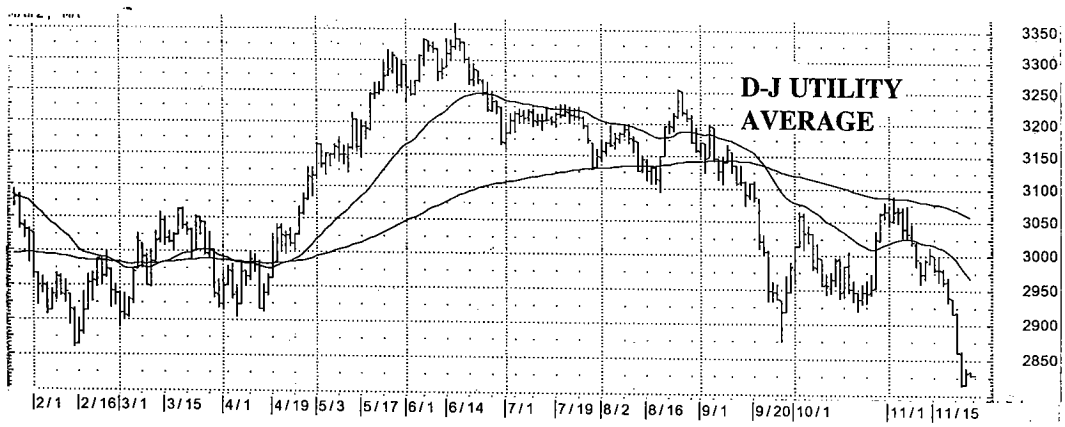
Y2K, how serious is it? Damn it, nobody knows -- and that's the core of the problem. You can bet that the Fed gets the best available information on Y2K. If so, their reaction in pumping up the money supply is pretty significant. Meanwhile, two weeks ago in a speech President Clinton told the nation that the Federal government was fully prepared for Y2K. But Washington's real concern is not large domestic corporations -- no, it's small business in the US and just about everything overseas. Is Russia compliant? Are China and other Asian nations compliant? What about the African nation and South

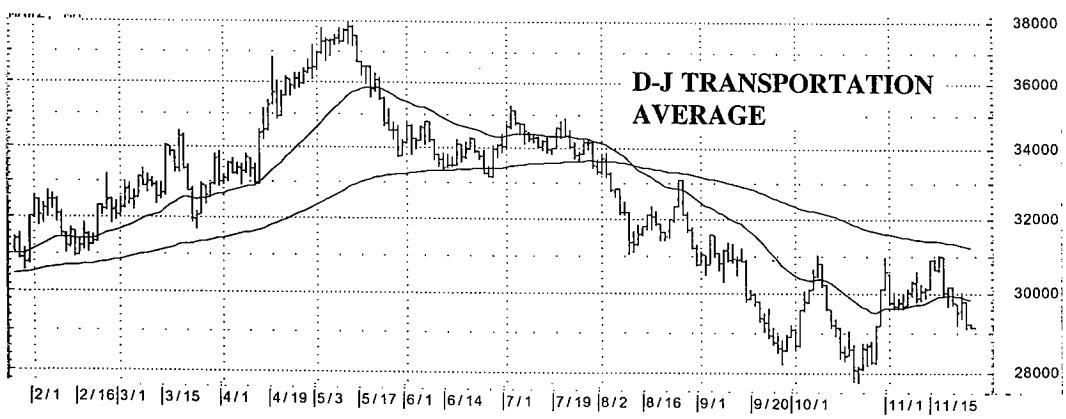




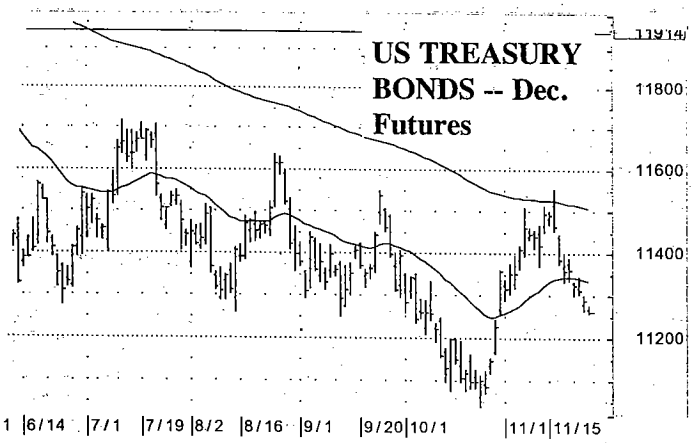
America? The possibility of malfunctions and break-downs is huge -- and absolutely unknowable.

Meanwhile, the great flood of money is washing into the stock market and into housing. And, I might add, into commodities. You know about stocks, you know about housing. As far as commodities, I show the Goldman Sachs Commodity Index on page 2.





I put myself in the Fed's position. They're saying, "Look, we flood the market with monetary reserves this side of Y2K and we take a chance of a market melt-up now and maybe a crash in early 2000. The alternative is that we keep the money supply steady now, Y2K hits and the markets collapse this year. In the first scenario, we're off the hook. We foresaw trouble and moved to a position of super-high liquidity. At least we weren't passive. We did our best to offset trouble. In the second scenario, the Fed gets blamed. Why didn't we see Y2K trouble coming? Why didn't we protect the nation? Why did we remain passive and stupid?" So the Fed has opted to protect itself from charges of incompetence and stupidity. The formula -- flood the nation with money and take a chance of a melt-up in stocks and commodities.



DIVIDENDS: When a few weeks ago four new stocks were added to the Dow, something unprecedented occurred. For the first time in history, stocks which pay no dividends were added to the Dow.

This is in harmony with the current trend, which is to give, by far, the greatest emphasis on growth, rather than on the return on the investment. The theory runs as follows: if a stock continues to grow, if it continues to increase its earnings, then why pay out good cash in the form of dividends when that same cash can be used by the corporation to grow, to add to its value.

This is a logical thesis, but it's a bull market thesis. And it's one that I believe will end up turning on investors. Let's picture an extended bear market -- I know this sounds well nigh impossible, but every bull market in history, big or small, has been followed by a bear market. Let's say that the bear market begins. Stockholders are sitting with stocks that pay little or no dividends (which, or course, is the position that they're in today). As their stocks decline, the stockholders have absolutely no protection. Earnings are declining, stocks are declining, a deepening recession is setting in, and stocks are offering nothing in the way of return.

Slowly, it dawns on investors that they are in a lose-lose situation. There is nothing coming in the way of dividends, and their stocks are fading away. In contrast, the holder of a stock that pays a good, well-protected dividend can think as follows: "All right, I'm receiving a 6% return on my stock. In three years, that's 18%. If my stock drops 20%, well, OK, I'm at least close to holding my own. So I'll just sweat it out."

The other factor is one that most of my veteran subscribers are familiar with. It's called **compounding.** I've always maintained that compounding is "the royal (safe) way to wealth" (see the compounding section on my website www.dowtheoryletters.com). If you're not receiving cash in the form of dividends, you can't compound. And if you can't compound, you're depending totally on capital gains. Problem: There are very few capital gains in a bear market.

Russell Prediction: As the bear market in the majority of issues is gradually joined by the big-cap and tech holdouts, the disaster of the no-dividend, zero-yield market will come to the fore. From that point on, it will not be a pretty picture, believe me.

INVESTMENT POSITION: I guess I should put both animals in the box, a bear for most of the stock market and a bull for selected big-caps, tech and nets. Since I'm dealing with the "market," which is MOST of the stocks, I'll stick with the bear in this box.

In my opinion, the single most difficult endeavor in the stock market is to stay with your discipline (assuming, of course, that you have a discipline). Frankly, I don't know of anyone who has operated successfully in the stock market over any length of time who does not follow a discipline. Ironically, what the stock market loves to do (both bull and bear) is to separate you from your discipline. I don't care whether you are a value investor, a momentum investor, or any other kind of investor, the stock market will do all it can to get you "off" your discipline. When that happens, the odds are that you will lose money.

My discipline is, and always has been, compounding. I stay with compounding no matter what the market does. The Dow can drop to 5000 or rise to 25000, I stay with my discipline of compounding. Compounding is, in some ways, the most difficult discipline. Compounding is also the only way I know of that, when executed correctly, guarantees wealth. It doesn't necessarily guarantee that you'll be a multi-millionaire; that's up to you. But it does guarantee, when followed correctly, that, given enough time, you will be reasonably well-off.

The discipline -- buy only very safe dividend paying stocks with attractive yields or safe interest bearing securities with attractive yields. The discipline -- you must reinvest most of your income, and do this month after month, year after year.

Sounds easy? It isn't. It isn't easy because the market will tempt you away from the compounding discipline. You will be tempted to buy hot, fast-rising dividend-less stocks in speculative companies. You will be tempted to "get with the program" and buy junk bonds or the red-hot stocks of the moment or to go on margin.

Conclusion: If you have found a system that works, stay with that system. And remember, the market will do all it can to lure you away from your system. That's where discipline comes in. If you don't have it-- you'll lose.

My own position requires me at this time to buy T-notes and the best-grade high-yielding preferred stocks. If you have a better system, use it, but remember, this is a bear market.

NOTES & QUOTES: Despite denial after denial, the Fed and the government are obviously very worried about Y2K. Almost daily we hear "everything's under control" messages from some government official. Last week, Commerce Secretary William Daley told the press that the US economy was sufficiently "stable, large and resilient" that failures, even those overseas, would not seriously affect the $9 trillion gross domestic product. "Any glitches that pop up next year should not hurt our economic growth," said Daley, "I am not going to lose any sleep."

Another government report released last Thursday predicted only a slight risk of "serious or widespread disruptions" in the nation's food supply. Expect a blizzard of "don't worries" and denials to come out prior to the end of the year.

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One of the ongoing arguments is whether the Fed can or actually is manipulating the market. The thesis is that the Fed through "surrogates" such as Goldman Sachs and Morgan Stanley will give orders to buy futures any time they think the market is in danger. Is this true? I don't know, and I don't know of anybody who has actual proof of Fed manipulation. I think the Fed does step in when they feel the market is in trouble. One fact is clear, however, and that is with the big averages dominated by maybe 10 stocks, it is easy for the Fed to manipulate either via big stocks or futures. But there's a second fact -- the Fed can't manipulate the advance-decline statistics. There you're talking about trying to manipulate the whole market.

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Check this out. American Express now offers the following: If you have $100,000 with them, all online stock trades (buying or selling) up to 3,000 shares are **free.** If you have $25,000 to $99,999 with them, you get free unlimited buys -- with sells at $14.95. If you have less than $25,000 with them, all online trades up to 3,000 shares cost $14.95. **Russell Comment:** For accounts of over $100,000, how can you beat this? Like all the other brokers, American Express wants to pull in assets. But for big accounts, this amounts to **murderous competition,** and you have to wonder how the whole brokerage situation is going to work out. With almost all brokerage houses forced to offer online service, what's going to happen to the tens of thousands of brokers who are working with firms that really don't want most of them? It's not a pleasant prospect, and it's one that will be faced in a great many industries.

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The four new additions to the Dow (MSFT, INTC, HD, SBC) will change the valuation for the Dow. The average P/E for the four additions is 41, while the average P/E for the four stocks removed was 24. The average dividend for the four additions is $0.32, while the average annual dividend for the four removed was $1.41.

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Could mutual funds be in danger, in danger of being replaced? The funds industry is already dealing with problems including anemic cash flows, competition from electronic brokers and lagging share prices for asset management firms.

Now, however, funds are facing increasing competition from a fairly new kind of investment product -- the exchange traded fund or ETF. These companies invest in indices. This gives the regular investor a level of flexibility that heretofore was only available to institutions. The ETF provides investors with low annual expenses. But even more important -- an efficient tax structure. Most ETFs are listed on the AMEX where their assets have risen from $2.4 billion in 1996 to $23 billion today. Typical ETFs are SPDRs which track the price of the S&P 500; the SPDRs now have over $14 billion in assets. Then there are the Diamonds which track the Dow. Unlike regular index funds, the ETFs do not pay out taxable dividends. But ETFs are traded like stocks, which means that buyer has to pay a commission. A recent popular ETF is HHH, which tracks a collection of 20 leading Internet stocks. Want to take a position in a foreign country? There are the WEBS, each an index on a different foreign nation. WEBS are also traded on the AMEX.

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Peter Drucker is probably the best known living futurist. He's also known as the "father of modern management." Recently interviewed in the *NY Times,* Drucker opines that in the future, people will not cast their lives with a single company. The so-called knowledge workers will save their best efforts for non-profit social service organizations, where they can make a bigger difference. Says Drucker, "The 20th century was the century of business, the next century is going to be the century of the social sector." Drucker is fascinated by the Internet, but he says his choice for the next 30 years is not e-commerce, "It's going to be fish farming where on the oceans we are still hunters and gatherers." **Russell Comment:** Drucker may be right about fish farming. Many species of fish are now becoming so scarce than it no longer pays to go out and fish for them on a commercial scale. And the world's daily consumption of fish is huge.

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The US will shortly come out with a new "Golden Dollar" coin. The coin will be significant in that it will fit vending machines that now offer dollar and multiple-dollar products (remember when a coke was a nickel and a good sandwich at the Automat was 15 cents?). The new Golden Dollar coin will be made of manganese, brass and copper. Pictured on the coin will be a Shoshone Indian woman who acted as a guide to Lewis and Clark on their expedition to the West Coast. The mint estimates a production of 100 million next year, much of which will be spent on coin-dispensing goods.

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The latest trade deficit figures are interesting. For September, the US deficit with China widened to $6.9 billion, the worst imbalance the US has ever recorded with any country. Imports from China soared to a record $8.2 billion, far exceeding the $1.3 billion the US exports to China. In contrast, the US deficit with Japan in September was $6.6 billion, the second highest imbalance on record. The entire US trade deficit for September was $24.4 billion -- the deficit is now running at an annualized rate of $256 billion, far ahead of last year's record imbalance of $164.3 billion.

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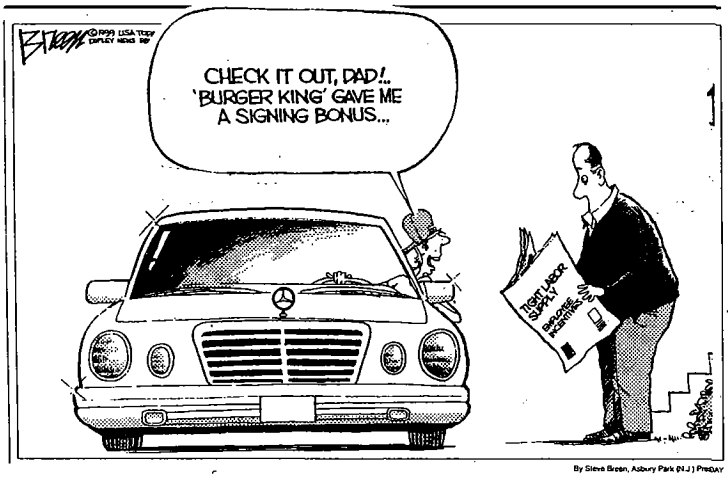
The following from the Nov. 15 weekly *Washington Post:* "We're moving into a post-PC world," says Robert Young, chief executive of Linus developer Red Hat, Inc., "and in that world, it's hard to imagine that Microsoft will be as dominant as they were in the 1980s and '90s." Microsoft's challengers aren't just on the outside. An estimated quarter of MSFT's 33,000 employees are millionaires because of stock options, giving them financial freedom to quit at any time. Although MSFT says its 79.4% attrition rate is less than half the industry average, the company is increasingly plagued by high-profile defections. In the past, about a dozen key managers and executives have either resigned or taken sabbaticals. In some cases, industry analysts say, the departures stemmed from disagreements with Gates over the strategic direction of new products. "Bill's position is that MSFT will embrace the Internet, but through the proprietary platform of Windows," says Michael Cusumano, a professor at the MIT Sloan School of Management. "There are some in the company who believe that is not the future -- that it's a dinosaur perspective. It's a critical debate in the company, and those who disagree with Gates are leaving."



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The race by Internet companies to reach brand-name status has taken on monumental proportions. Ironically, the media the net stocks are turning to in this titanic battle are the oldies -- newspaper, TV, magazine, radio. The major problem with Internet merchandising is that any little pipsqueak outfit can take on any other outfit; by that I mean the pipsqueak can set up a website and advertise the same or comparable merchandise at cut-throat prices, which, of course, is exactly what is happening.

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China into the World Trade Organization? What does it mean? Clinton wants it as part of his legacy (his legacy needs whatever it can garner at this point). Chinese prime premier Zhu Rongji has staked his future on reform and China's joining the WTO. Clinton changed his mind a year ago, saying he would no longer link human rights or missile proliferation with annual renewal of Chinese trading rights with the US. If China is voted into the WTO, many barriers against selling goods to China will be reduced, including movies, telecommunications, banking, autos, agriculture. China's membership in WTO would mean greater openness, more press freedom, enhanced rights for workers. US business hopes the deal will add one billion customers to its sales potential. The treaty still has to be approved by the House where conservatives want no part of any deal with China and where liberals are afraid that a deal with China will cost US jobs. Approval by the Senate is more certain. It's going to take time.

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The *WSJ* (Nov. 14) finally published an article addressing the incessant press releases that have been part of the Internet companies' arsenals. The new law, says the *WSJ*, is not "Buy on the rumor, sell on the news." No, the new axiom is "Buy on the press release, sell on the news." With very few Internet companies showing any earnings, the press release is their best avenue for hype. Some net companies, writes the *WSJ*, churn out so many press releases that it alarms the analysts. Continues the *WSJ* article, "It all raises the question whether a price-to-press release can be far behind. 'For a significant percentage of companies, press releases are all they have,' says Henry Blodget, Merrill's Internet analyst." For some Internet start-ups, picking a public-relations official has become the first order of business. Some fledging concerns put this ahead of say, picking a chief financial officer.

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Maureen Dowd, op-ed columnist for the *NY Times*, makes fun of Donald Trump's possible run for the presidency, and her description of the current US is not kind. "The flirtation of the Trumpster, as he calls himself, is the apotheosis of our Gilded Age. Our politics are warped by money, celebrity, polling and crass behavior, and our culture is defined by stock-market high-rolling, boomer narcissism, niche marketing mania, rankings and a quiz show called, 'Who Wants to be a Millionaire?'"

Russell Comment: It seems that the US (and maybe most nations) need some kind of obsession to zero in on. For decades, our obsession was the menace of the Soviets and Communism. Once the Soviets collapsed we attempted to turn our obsession to the menace of China, but that potential obsession seems to be fading away. There's no question in my mind that the real current obsession is money, making money, and the stock market.

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If it's weird, it probably comes from California. Here's a beaut, it comes from the Nov. 17 *LA Times*. It's the story of the Rossi couple who won $1.3 million from the California lottery. But wife Denise wanted out of the marriage, so she hid the winning ticket from her husband. Eleven days after winning the lottery, she filed for divorce, hoping to keep the whole $1.3 million for herself. Bad decision. She was found out, and an LA family court stated that she had violated state asset disclosure laws. The court awarded the whole $1.3 million to her husband.

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Donald Trump, a possible Presidential candidate, has a plan to get the US out of debt. He'd tax the rich about 17% of their assets. You have to wonder, however, since Trump hasn't done that well with his own publicly owned stock, DJT. Trump brought Trump Hotels & Casino Resorts public at $14 a share. DJT (on the NYSE) got as high at $35.50 in '96. But from there the stock (which never showed a profit) headed down. Losses mounted with an estimate of a loss of $1.75 per share for this year. In the meantime, the stock has dropped to $4. Trump holds 41% of the stock, although he is neither president nor CEO. Last year debt on DJT was 641% of equity. So far, it seems, Trump is no master of mastering debt.

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Often, I find that cartoonists are better than anyone else in getting to the heart of a matter. Humor has a way of zeroing in on an idea or a trend in a way that is sharper and more convincing that a five thousand word essay on the subject -- usually an essay that nobody wants to read.

The urge to merge. If the trend keeps up, it does look as though three-quarters of all the companies in the nation will end up as divisions of about 10 big corporations (just kidding). But this cartoonist is thinking that way, and who knows, he could be right.

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The latest issue of *Smart Money* magazine features, "The 10 Stocks for the Next Decade." Actually, this magazine did very well on its 10 stocks for the '90s, so here's their new list: **America Online, Broadcom, Citigroup, Inktomi, MCI Worldcom, Monsanto, Nokia, Nortel Networks, Red Hat and Scientific Atlanta. Russell Opinion:** I think it's a pretty good list.

* *

One thing bothers me, and it's that I can't fathom how this whole Internet world is going to work out. I'm convinced that there's going to be massive consolidation of the Internets (of course this is already happening), and I'm also convinced that a huge percentage of the net companies are not going to make it. Finally, I'm just not sure how the net companies, at least most of them, expect to generate profits. It's OK to count eyeballs but that game can't continue for long. If you're in business, you MUST generate profits.

So far, the biggest profits in the Internet phenomenon have gone to the recipients of net advertising. *Fortune* magazine (Dec. 6), in an article entitled, "Dot-Com Time Bomb on Madison Avenue," states that "Net companies are spending hundreds of millions to build their brands. Problem is, it's all going to stop after Christmas . . . Advertising is an industry that thrives on superlatives, but to put it bluntly, Madison Avenue has never seen a boom as explosive, spectacular and sudden as the Great Dot-Com Ad boom of 1999! Ads for Internet companies are everywhere -- TV, newspapers, radio, magazines, taxicab tops, even hot dog stand umbrellas. Paine Webber estimates that the dot-coms will spend $1.9 billion by year's end, 15 times what they spent last year. Want to place an e-ad on cable? It will cost you 21% more than last year. On a network? At least 16% more. Taxicabs will cost you 30% more. Says Aaron Cohen, head of Broadcasting for Horizon Media, 'Spending on virtually all media has gone berserk.' Where do the companies with next to or no revenue get the money to pay for millions of dollars worth of advertising? Simple: from venture capitalists, who in the second quarter of this year invested a record amount of money in new companies -- nearly $7 billion, up from $3.3 billion during the same period last year. . . . Madison Avenue enjoyed a 2287% hike in dot-com advertising in the first half of 1999; it might still suffer a decline nearly as sharp in the first half of 2000. The ad folks grumble about their dot-com clients now, but by next summer they may well remember these mad, mad, days of Internet mania more fondly." **Russell Comment:** It's a giant game backed by fantastic optimism, huge liquidity, greed and some spectacular successes (successes in the way of booming the stock prices -- the big profits, any substantial profits, have yet to appear). My guess -- there'll be more money lost on net stocks than gained. But it will take time.

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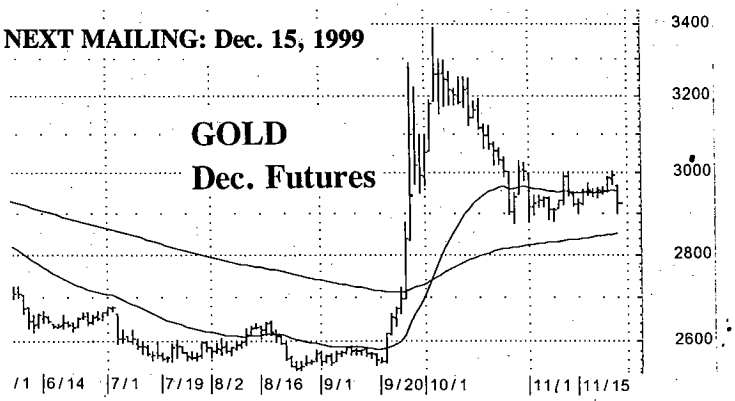
Last week Hillary finally declared that she would run for the Senate out of the state of New York. Maureen Dowd, probably the *NY Times'* most popular op-ed columnist, put the matter into perspective (Nov. 24): "One would think that eight years running the country is a pretty good shot at getting your business done. But there's something so rootless and chaotic about the Clintons. They seem like a virus or alien that needs a host body to survive. They've invaded our national psyche and we're going to have to keep living with their weird marital problems and tangled ambitions forever and ever. Their business will never be finished. They are never going to go away because they have no place else to go. They will get some worthy things done, but they will also be in our faces, exhausting us with their, 'We want to do good, so we can break the rules when we need to' ethos." **Russell Comment:** Hillary will soon be moving to Chappaqua, NY while Bill remains in Washington. Sounds like a "trial separation" to me. Personally, I'm ready for a full and permanent separation from both Clintons. I almost wish I was back in NY again, so I could vote for the mayor.

GOLD: I'm going to make this a very simple but important study of price action. Referring to the daily chart -- first we had the powerful September-October surge that advanced December gold to a high of 338 on October 5. That surge also took the 34-day moving average well above the longer 144-day moving average. Then we had the correction in gold back to the 288.10 low of November 5.

But note, and this is important, that the correction was not powerful enough or extended enough to push the 34-day MA back below the 144-day MA. That was bullish action, indicating basic strength. Then on November 23 we saw Dec. gold climb back ABOVE its 34-day MA. That also represented good action.

But on November 29, Dec. gold opened down over 7 dollars at 291.30 -- again below its 34-day MA. Blame it on a sale by Britain, but also blame it on lack of demand.

NEXT MAILING: Dec. 15, 1999



LATE NOTES: The "split" market continues -- techs and nets, in general, strong while the majority of "old economy" stocks sink. I'm reading justifications for various Internet stocks selling at price times sales, with some stocks with sales of $10 or $15 million (no earnings) selling at market valuations of over $1 billion. Insanity? I think so. The theory, of course, is that these are stocks in such a hot industry that as sales increase it's only a matter of time before these companies will somehow generate earnings. Will it happen? In some cases it will, but in my opinion in most cases it will not.

With signs of inflation becoming so blatant that even the Fed will soon be forced to pull its head out of the sand, bonds continue to decline. The bond market leadeth, and the Fed reluctantly followeth.

In the meantime, Europe watches nervously as its new currency, the euro, sinks down to almost par with the dollar. Why? US economy strong, Japan's economy picking up, while Europe's economy is still sputtering. And there's that question I've been asking for years -- why should I pay $90 for a dinner in Paris when I can get one just as good for half the price in an expensive NYC restaurant?